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EI REFORM: PART I

Getting Off the Rollercoaster: A Stable Funding Framework for the EI Program

By
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- While the public debate over reforms to Employment Insurance centres on regional fairness in eligibility requirements, it is critical that the EI program remain affordable in good times and bad.
- To avoid pro-cyclical EI premium decreases during booms and harmful premium increases during downturns, the challenge is to create a rate-setting mechanism that would balance the books over the ebbs and flows of economic cycles, and permit yearly EI account balances to vary.
- Ottawa also needs to introduce reforms that insulate the EI fund's management from political interference – and protect that fund from governments that would dip into EI surpluses for general spending. One model is the Canada Pension Plan Investment Board.

Under the current Employment Insurance (EI) premium rate-setting mechanism, Canada's recently poor economic performance would have, without federal intervention, forced premiums to increase in 2010. That would have placed a fresh tax burden on employees and employers just as recovery was likely to take hold. The February 2009 federal budget postponed the inevitable rate increases, but looking to 2011 and beyond, the mechanism clearly needs repair.

Over the last two decades, EI premium rates were generally set higher than break-even levels (Figure 1).[1] The resulting surpluses went to the federal budget's bottom line, meaning the program labelled EI was funding general government expenditures, and that the federal fiscal balance, then looking strong, was not quite what it seemed. The result was blurred accountability in EI program funding and management, accompanied by the growing of non-insurance benefits within EI, such as fishing and parental benefits, far removed from EI's original income insurance rationale (Poschmann and Robson 2001).

History is set to repeat itself. The 2009 federal budget foresees sharply rising EI premiums beginning in 2011, resulting in EI contributions that exceed benefits by about $3.4 billion in 2013/14. With a slim budgetary surplus of $700 million projected for the same year, the federal government risks again becoming dependent upon EI contributions and EI account surpluses to balance its budget.

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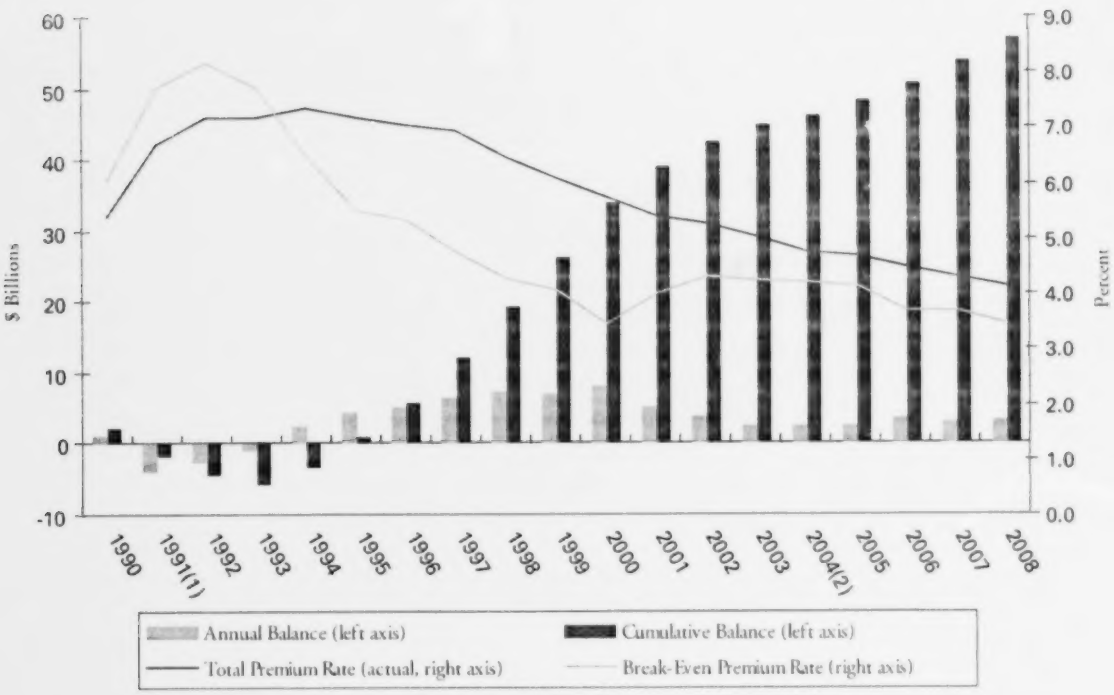
1 The employee premium rate is the policy rate chosen each year. Employers pay 1.4 times the chosen employee amount. The employee rate for 2009 and 2010 is 1.73 percent of insurable earnings. Including employer contributions, the total premium rate is 4.15 percent, much higher than the employee rate alone.

Figure 1: Total Premium Rates, Break-even Rates, Annual Balance and Cumulative Balance, 1990 to 2008



Sources: CIA (2007); Public Accounts; HRSDC, Outlook for the EI account in 2004; Various Chief Actuary Reports on EI Premium Rate; and authors' calculations.

Notes: 1) In June 1991, the total premium rate changed from 5.40 percent to 6.72 percent due to the intervention of the Minister of Human Resources.
2) Annual surplus results from this date forward are authors' calculations based on public accounts figures and the Fiscal Monitor.

Today's policy challenge is to create a rate-setting mechanism that would achieve a relatively stable premium rate that would balance the books over the ebbs and flows of economic cycles, by allowing yearly EI account balances to vary. This would avoid pro-cyclical rate decreases during booms and harmful premium increases during downturns (see Appendix Box A1 for a short history of EI financing).

To avoid the likelihood of political pressure again overwhelming the rate-setting mechanism, Ottawa needs also to introduce EI Account Management reforms that fully insulate the EI fund's management from political oversight. One model is the Canada Pension Plan (CPP) and the CPP Investment Board, which invests the CPP Fund independently from political influence. If such governance reforms were undertaken, EI finances could be separated from the annual budgetary bottom line, and EI's net revenue would not affect the budget balance. Together, these reforms should establish fiscal integrity in a program whose accountability and purpose have become murky over time.

Box A: Methodology: Future Unemployment Rates and EI Finances

Empirical investigation of alternative economic scenarios helps understand the likely evolution of the EI Account's annual balance, cumulative balance and premium rates under existing rules and an alternative rate-setting mechanism.

Using the sensitivity analysis from the Chief Actuary's 2009 Report to the EI Commission, our future projections simulate the results on the EI Account – net of administrative costs – should the changes to unemployment rates in the two most recent recessions manifest themselves in upcoming years.[2] A third scenario projects the outcomes in a milder downturn.

The unemployment results for 2009 and beyond use the year-over-year changes to unemployment beginning with the first year of previous downturns. Subsequent year-over-year changes then follow. Note that the length of the projection period, or the duration of the business cycle, is nine years for each scenario.[3]

The Chief Actuary's sensitivity projections also take into account, albeit with less emphasis, changes in the ratio of EI beneficiaries to unemployed workers. Our simulations examine possible future variations, for each scenario, given the history of the early 1980s recession.[4]

Further, though interest income is not currently used to determine future premium rates, we include interest income in each of our account balance scenarios to reflect the operation of an independent account.[5] We also assume an initial balance of $2 billion, the level prescribed in the 2008 Budget.

The Current Rate-Setting Method Inadequately Copes with Business Cycles

During the recessionary phase of the business cycle, premiums are sure to rise (Table 1). Under existing rules the Canadian Employment Insurance Financing Board is required to increase EI premiums to a level that not only ensures the program breaks even on a yearly basis, but also replenishes any potential amounts drawn down from the reserve.[6]

For the most severe scenario, the 1980s downturn, a strict application of this mechanism would require the premium rate to increase by about 1.95 percentage points in 2011 – more than 13 times the annual legislated premium change limit of 0.15 percentage points. Should rate hikes be held to the 0.15 percentage points limit, deficits will emerge and a pattern of rate increases and decreases occur over the projection period.[7] This process's obvious drawback is that it excessively focuses on a specific goal – the annual balancing of the books – instead of concentrating on the real objective – that is, the cumulative account balance over the business cycle.

2 For complete details on revenue sensitivities, see Human Resources and Skills Development Canada, *Report of the Chief Actuary to the Employment Insurance Commission on the Employment Insurance Premium Rate and Maximum Insurable Earnings for 2009*, pp. 9 and 10.

3 The term business cycle, although lacking a generally accepted definition, was undefined in the 1996 *EI Act*. For the purpose of this paper, we simply define a business cycle as the annual up and down movements – the expansions and contractions – of the Canadian economy around its long term trend. See Cross (1996) for a complete discussion of this term. Business cycles are undefined in duration, because no cycle perfectly matches a previous one. For our purposes, we take into account the most recent experience of business cycles. Cross (1996) found the cycle duration, peak to peak, was roughly 8.75 years from 1982 to 1990. The subsequent contraction and expansion in the 1990s was related in severity and duration. We focus on the manifestation of business cycles in unemployment rates. More use of stochastic projections would yield a more robust forecast of EI account balances.

4 The beneficiaries-to-unemployed (b/u) ratio's recent history is one of significant structural change (HRSDC 1998, Kerr 1999). Program reforms and a significant expansion of self-employed workers have brought the ratio down from around 80 percent in the 1980s to fewer than 50 percent in current periods and have brought into question the ratio's significance as an indicator of EI coverage. Despite numerous unsuccessful attempts to predict the ratio's future path, we do agree with previous projections that overall pressures should push the ratio upwards (Sargent 1998) and we therefore assume for each scenario that the b/u ratio will move upwards much like it did in the 1980s recession, fall somewhat, and then flatten out.

5 Our projections use a real interest rate of 1.61 percent, based on the annual long-term government bond yield on January 5, 2009, and 2 percent annual inflation, the central point in the Bank of Canada's inflation targeting band. The notional interest rates that currently apply to the EI account's cumulative surplus – 90 percent of the monthly average of the three-month T-bill rate – is chosen by the Minister of Finance, and we feel that this rate is unfairly low, thereby underestimating the reasonably attainable levels of interest income.

6 The Financing Board manages a separate bank account in which a $2 billion cash reserve must be maintained.

7 It is important to remember that the numerical examples demonstrate only an approximate application of the formulas and principles embodied within the rules for each approach. The actual course of action under each scenario could change depending on outside influences.

Table 1: Downturns Place Upward Pressure on Premiums: End-of-Year Employment Insurance Account Balance Projections, 2009 to 2017

Projections Using Current Rate-Setting Mechanism

			2009	2010	2011	2012	2013	2014	2015	2016	2017
1980s	Balance	Annual	-7.7	-9.2	-5.4	-2.2	1.3	4.3	7.6	8.2	6.6
Downturn	(2009 $billion)	Cumulative	-5.7	-15.0	-20.6	-23.2	-22.3	-18.3	-11.0	-3.0	3.5
	Premium Rate (%)		4.15	4.15	4.51	4.87	5.23	5.59	5.95	5.95	5.59
1990s	Balance	Annual	-5.8	-7.4	-4.8	-1.0	2.4	3.8	6.4	6.0	5.5
Downturn	(2009 $billion)	Cumulative	-3.8	-11.3	-16.2	-17.5	-15.4	-11.8	-5.6	0.4	5.9
	Premium Rate (%)		4.15	4.15	4.51	4.87	5.23	5.59	5.95	5.59	5.23
Mild	Balance	Annual	-4.4	-5.3	-2.5	0.5	3.1	4.7	3.5	2.6	1.5
Downturn	(2009 $billion)	Cumulative	-2.4	-7.7	-10.4	-10.1	-7.1	-2.6	0.9	3.5	5.0
	Premium Rate (%)		4.15	4.15	4.51	4.87	5.23	5.59	5.23	4.87	4.51

Projections Using Proposed Mechanism

			2009	2010	2011	2012	2013	2014	2015	2016	2017
1980s	Balance	Annual	-7.7	-9.2	-4.6	-1.5	1.5	2.9	4.5	5.1	5.1
Downturn	(2009 $billion)	Cumulative	-5.7	-15.0	-19.9	-21.6	-20.5	-17.9	-13.7	-8.9	-3.9
	Premium Rate (%)		4.15	4.15	4.68	5.04	5.28	5.28	5.28	5.28	5.28
1990s	Balance	Annual	-5.8	-7.4	-4.0	-0.2	1.5	1.3	2.2	3.5	4.6
Downturn	(2009 $billion)	Cumulative	-3.8	-11.3	-15.4	-15.9	-14.7	-13.6	-11.6	-8.3	-3.8
	Premium Rate (%)		4.15	4.15	4.68	5.04	5.04	5.04	5.04	5.04	5.04
Mild	Balance	Annual	-4.4	-5.3	-1.7	0.1	1.1	1.0	1.5	2.2	2.8
Downturn	(2009 $billion)	Cumulative	-2.4	-7.7	-9.6	-9.6	-8.7	-7.8	-6.4	-4.3	-1.5
	Premium Rate (%)		4.15	4.15	4.68	4.80	4.80	4.80	4.80	4.80	4.80

Sources: Authors' calculations based on 2009 Report of the Chief Actuary to the Employment Insurance Commission.

Reforming EI Financing

We propose to reform the financing of the EI program by adopting a new rate-setting mechanism. To be sustainable, this mechanism must be robust to the policy pressures that undermined the 1996 mechanism, and this requires reforming the EI Account's management framework.

A New Rate-Setting Mechanism

We propose that a relatively constant premium rate be determined on an actuarial basis to ensure the EI account's cumulative balance, over the medium term, remains within reasonable boundaries – say within plus or minus $15 billion. The Chief Actuary would be tasked with finding the rate that would balance the account.[8]

If the EI account's cumulative balance moved out of the boundaries – reflecting a structural change in unemployment or benefit levels – an automatic process would increase or lower the premium rate for the long term. This way, as the economy headed into a downturn, the premium rate could be kept constant as deficits were incurred. Then, as the economy recovered, revenues would rise, deficits could be repaid, and surpluses would accumulate, all the while holding premium rates steady.

EI Account Management Needs Reform

Reasonably stable EI premiums are not a guaranteed result of an appropriate rate-setting formula: forecasts are imperfect, changes to program benefits can occur with little warning[9] and, as recent failures suggest, the system of governance can exert significant influence on the choice of rates when EI contributions become central to the overall budgetary policy of the government.

Triggered by 1996 reforms, a massive EI Account surplus accumulated because rates were chosen not only to serve the interests of program contributors but to achieve fiscal goals as well (Poschmann and Robson 2001). In other words, the federal commitment to yearly balanced budgets conflicted with the objectives of the EI Account rate-setting mechanism. Even though enough reserves were accumulated in the EI account to ensure rate stability over the business cycle, drawdowns on those reserves in any given year would have had a direct negative impact on the federal overall budgetary balance in that year.

One way to completely isolate EI program finances from federal budgetary policies would be to separate the EI account from the Public Accounts of Canada, and to manage the separate Account transparently at arm's length from the federal government.[10] In its current form, however, segregating the EI account may violate the broad public accounting principle that a government's financial statements should comprise all activities and organizations controlled by that government.[11]

To comply with public accounting standards, a number of changes would be needed to lessen the federal government's influence over the EI program's operation. For example, the federal government should not have the power to, or be involved in, appointing or removing a majority of the members of the board, which would set contribution rates and manage the finances of the program. Nor should government be involved in budget approval for program administration. In addition, the design of benefits and contributions should be enshrined in legislation – not in regulation – ensuring that the federal

8 In 1998, the Chief Actuary of the EI program recommended that the rate be set at approximately 1.90 to 2.10 percent over the upcoming business cycle. The actuary also recommended a reserve fund of between $10 and $15 billion to support revenue shortfalls in a recession. In 2000, the recommended stable premiums were between 1.70 and 2.20 percent with a reserve of $15 to $20 billion. However, rates were set at levels much higher than those proposed by the Chief Actuary (CIA 2007).

9 Section 66.2 of the *EI Act* requires EI's Chief Actuary to use the Ministry of Finance's economic projections in his or her forecast of the break-even premium rate. Because downturns can be abrupt, further reforms should allow the Chief Actuary more independence to gauge the up- and down-side risks.

10 The desire for an off-budget account was expressed by the Canadian Institute of Actuaries (CIA 2007), the International Labour Office (Plamondon et al. 2002), and during recent public consultations with business and labour groups (Canada 2003).

11 Public Sector Accounting Handbook, Section PS 1300.07.

government could not unilaterally change the design of the program without the consent of Parliament.

If the government is unwilling to adopt the proposed governance reforms, and balancing accounting principles with macroeconomic stability objectives proves cumbersome, Ottawa should take other steps to distance EI accounting from the federal bottom line. For example, the EI account's annual balance could be removed from consideration in budget planning – the government policy would target a bottom line that excluded EI. The EI account would then still be part of federal financial statements.

Conclusion

Raising taxes in bad times and lowering taxes in good times deepens economic cycles and reduces any program's ability to act as an automatic economic stabilizer. We see our proposed reform – allowing for relative rate stability through a renewed formula and reformed management of program finances – as crucial to the long-term legitimacy and credibility of EI program financing.

Appendix

Box A1: A Brief History of EI Governance and Rate-Setting Rules

Since the Second World War, the EI account has seen numerous reforms to its governance structure and its premium rate-setting rules (Table A1). For most of its history, the federal government was a major contributor to EI revenues. In 1986, on the recommendation of the Auditor General, the Unemployment Insurance (UI) Account, as it was then named, was consolidated with the government's public accounts to present a comprehensive view of government activities, because to do otherwise would obscure a contingent liability to which federal taxpayers are ultimately exposed.

The government halted transfers in 1990, making the financing of the program entirely dependent on employer and employee contributions. Since then, uninsured individuals – mostly the self-employed who represent more than 15 percent of Canada's labour force – do not contribute to the program through transfers from general government revenues.

The *Unemployment Insurance (UI) Act* of 1971 created a rate-setting mechanism based on three-year historical break-even rates, giving rise to a problem of pro-cyclicality – rising premium rates in bad economic times (Kerr 2005). This contributed to the need for 1996 reforms to the *Employment Insurance Act,* which set in place the requirement for a relatively stable premium rate over the business cycle.

Annual surpluses grew, however, and from 2001 to 2005 the rate-setting process was suspended and rate-setting powers handed over to the governor-in-council (Cabinet).[12] In 2005, the federal government introduced a new rate-setting mechanism, which stipulated that the next year's projected revenues must equal projected expenses; however, the premium rate could not change by more than 0.15 percentage points from the previous year's rate. Finally, in 2008, the government created an independent body, the Canada Employment Insurance Financing Board, to ensure that future EI premiums be dedicated exclusively to benefits. The current rate-setting mechanism will not be fully implemented until 2011, since the rate for 2010 was fixed by the February 2009 federal budget.

12 The Supreme Court of Canada ruled on December 11, 2008, that the federal government transformed EI premiums (collected for specific purposes) into payroll taxes (collected for general purposes) in 2002, 2003, and 2005, and declared this practice illegal unless it can be clearly demonstrated that Parliament intended to delegate its taxing power authority to the governor-in-council.

Table A1: Rate-Setting Regimes and Governance of the Employment Insurance Account

Period	*Rate-Setting Rules, Governance Structure, and Role of Actuary*	*Government Funding*	*Ministerial Override Powers*
1941 - 1971	No specific rules. Goal was to keep system in financial equilibrium. The Unemployment Insurance Commission, a tripartite body with labour, business, and government representation, determined rates. UI Account off-budget, and actuary provided advice on rate levels.	20 percent of employer-employee contributions and administrative fees.	No
1972 - 1996	Rates set annually by UI Commission, subject to government approval. Rates were chosen according the last three-year average of benefits plus (minus) any amount required to remove or reduce a deficit (surplus) in the UI Account. Actuarial advice given in-house.	Government would support costs when unemployment rate increased.(1) No longer paid for administration fees.	No
1976	Same as above	The Commission raised rates to cover the transfer of $500 million in costs from government to private firms.	No
1978	Commission brought under department of Manpower and Immigration. Deputy Minister becomes automatic chair of commission.	Same as above	Yes
1986	Account is made part of federal budget and consolidated with Public Accounts of Canada.(2)	Same as above	Yes
1990	Government contributions from general revenues completely eliminated in 1990. Increase on private sector costs of approximately $1 billion.	None	Yes. Used to set rates in 1990, 1992, 1995, & 1996.
1996 - 2001	Renamed Employment Insurance Commission. EI Commission aimed for relatively stable rate over the business cycle while ensuring that there was enough money over the business cycle to pay for charges in EI Account. The actuary calculated rates according to business cycle break-even amounts and suggested rates to commission. The EI Commission initially kept rates high during 1996 and 1997 to build up a reserve. (3)	None	Yes
2002 - 2005	No set rules. EI Commission no longer in charge of setting rates. Instead, rates are to be set by governor-in-council (cabinet), on advice of minsters of Finance and HRSDC.(4) Account remains consolidated. The Chief Actuary advised on break even rates for upcoming year, using economic projections of Department of Finance.	None	Not needed
2005-2008	EI Commission put back in charge of setting the premium rate. Premium rate is set in a forward-looking manner such that projected premium revenues equal projected benefit payments for the next year, taking into account the Chief Actuary's report and public input, if any. Premium rate cannot change by more than 0.15 percent from previous year's rate.(5)	None	Yes
2009 -	Budget 2008 created the EI Financing Board, an independent crown corporation, to oversee the finances of the EI account starting in January 2009. Rate-setting rules remained largely unchanged but EI premium revenues are now dedicated for the exclusive use of the EI program. Actuary's role is same since 2005.	None	Yes

Sources: CIA (2007), Report of Chief Actuary 1998, Budget 2008.

Notes: 1) Initially, all costs when the unemployment rate rose above 4 percent were covered, but this guarantee began to fade around 1976.

2) The reason for making the UI Account part of the Public Accounts is based on the recommendations of the Auditor General, who recommended in 1983 that the account be consolidated to present a comprehensive view of the government's activities.

3) Notably, the EI Commission did not act upon the recommendations of the Chief Actuary from 1998 to 2001, and instead chose to keep premium rates high in accordance with the government's overall fiscal objectives.

4) In 2006, the rate was set in legislation. In 2002, 2003, and 2005, premiums were set by the governor-in-council. The Supreme Court of Canada subsequently ruled on 11 December 2008 that the federal government transformed EI premiums (collected for specific purposes) into payroll taxes (collected for general purposes) in 2002, 2003, and 2005, and declared this practice illegal unless it can be clearly demonstrated that Parliament intended to delegate its taxing power authority to the governor-in-council.

5) The rate mentioned in this period applies to employees. Employers pay 1.4 times the employee rate; hence, the total rate can only move by a maximum of 0.36 percentage points each year.

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